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Federal contractors to face much closer scrutiny

By Heather James

According to a recent report of the Government Accountability Office (GAO), the U.S. government spent \$388 billion on contracts and grants in 2005 and even more last year, representing about a quarter of the government's annual discretionary spending budget.

Yet despite steady increases in government contract spending, the federal procurement environment has become increasingly precarious, due in part to a recent flood of newsworthy scandals involving government contractors and the absence of adequate government controls over procurement activities.

Contracting practices related to domestic spending at the Department of Homeland Security have received considerable negative publicity over poor agency contract management and ballooning contract cost overruns.

Stories detailing fraud, waste and abuse in Iraq reconstruction contracts are often front page news. Katrina relief and rebuilding efforts have been plagued by reports of contract over-billing and inadequate prime- and sub-contractor supervision.

The GAO's report, issued in November 2006, said much of the money spent on federal procurement was exposed to "potential waste and misuse" because of the way the government currently conducts business with private sector contractors.

The GAO has called on government agencies to crack down on procurement fraud and other illegal contracting practices. Congress is also proposing strong measures to tighten the procurement process. And the U.S. Department of Justice has announced its commitment to increase civil and criminal prosecution of contractors allegedly engaged in procurement fraud activities.

What will all this mean for government contractors in the coming year? Although much of the media focus in recent procurement scandals has revolved around a handful of the largest government contractors, heightened government scrutiny will be felt by contractors of all sizes and at all levels of government contracting.

Increased Congressional and agency oversight

When the Democrats take control of the House in January, Rep. Waxman (D-Calif.) will assume leadership of the House Government Reform Committee, a powerful group that monitors federal contracting activities and government acquisition reform.

In 2006, Waxman introduced proposed legislation designated as the "Clean Contracting Act of 2006," which is intended to "promote greater transparency and accountability in federal contracting."

The bill is currently in committee and may reach a floor vote in the first half of 2007. The principal effects of the measure include strict limitations on subcontract tiers under prime contract vehicles; a sharp reduction in the number of noncompetitive, cost-plus and "other transaction" contracts awarded; and a significant increase in spending for congressional oversight and government agency audit activities.

Waxman's bill also proposes to extend from one to two years the minimum time a contracting official must wait after leaving the government before accepting employment with a company previously under his or her contracting authority.

Additional legislation is expected to be introduced this year calling for increased oversight and accountability of defense contractors performing Department of Defense Iraq military and reconstruction contracts.

Contractors and industry associations are closely watching the progression of Waxman's bill and similar proposed legislation because if passed, these laws would mark a sea change in the way the U.S. government buys its goods and services. Whatever the outcome of the proposed legislation, the government will be tightening controls over its procurement practices, and government contractors can expect to conduct future business with the government in a much more transparent environment.

DOJ's new procurement fraud task force

The U.S. Department of Justice is also raising the stakes of contractors' potential missteps in the federal contracting marketplace. In October 2006, the DOJ created a new Procurement Fraud Task Force, which will investigate and prosecute procurement fraud under the False Claims Act, 31 U.S.C. § 3729, et seq. (FCA).

Under the civil prong of the FCA, entities who knowingly submit false claims, or cause the submission of false claims, are liable for three times the government's calculated losses, plus civil penalties of \$5,500 to \$11,000 for each FCA violation.

The task force, which operates out of DOJ's Criminal Division, will aggressively pursue contractors and individuals under the FCA's criminal provisions, which provide for criminal penalties including jail time for serious violations. The task force will coordinate its efforts with local agency offices of the Inspector General (OIG) and federal law enforcement groups.

So far, the government's efforts to pursue civil and criminal fraud penalties against contractors and their employees have paid off big time. In fiscal year 2006 alone, the U.S. government recovered over \$3.1 billion in settlements and judgments against companies it sued under the civil provisions of the FCA.

Government-initiated FCA cases accounted for approximately \$1.8 billion of recovered funds, while suits brought by whistleblowers under the FCA's qui tam

provisions accounted for the remaining \$1.3 billion. Defense procurement fraud cases accounted for \$609 million, or 20 percent of all recovered funds.

Since all of these figures were compiled before the DOJ's new task force began its work, contractors can expect a significant increase in the recovery amounts in 2007 under the FCA resulting from DOJ, agency and federal law enforcement investigations, lawsuits and prosecutions.

Whistleblower lawsuits likely to increase

In addition to increased scrutiny from congressional and enforcement agencies looking to crack down on procurement fraud, government contractors should be warned that the number of whistleblower, or qui tam, lawsuits filed under the civil prong of the FCA are also on the rise.

Whistleblowers with knowledge of potential procurement fraud have big financial incentives to assist the government in pursuing FCA cases against contractors. If the United States intervenes in a qui tam action, the whistleblower who filed the suit may receive from 15 to 25 percent of the government's recovery.

If the government declines to intervene and a whistleblower successfully prosecutes a FCA case against a contractor, the whistleblower can keep up to 30 percent of recovered funds. In fiscal year 2006, whistleblowers were awarded over \$190 million in awards and settlement funds.

The players in whistleblower lawsuits are also changing. They are no longer just disgruntled former employees. A contractor's competitors or even subcontractors will now initiate FCA litigation.

And in 2007, the U.S. Supreme Court may make it even easier for whistleblowers to successfully pursue qui tam FCA cases against government contractors.

The court recently heard oral argument in *Rockwell International Corp., et al. v. United States, et al.*, a 21-year-old procurement fraud case in which the court will decide how much information and first-hand knowledge of potential fraud a whistleblower must have to bring a claim against a contractor under the FCA.

What is procurement fraud?

What is procurement fraud under a government contract? FCA cases are based on a contractor's submission of one or more false requests for payment, or any false statements made in order to get false claims approved and paid.

The DOJ is prosecuting more cases under the FCA, including a surprising number of situations beyond just overcharging and fraudulent invoice issues. The DOJ now treats many contract violations as fraud against the government. Procurement fraud can be anything from the mishandling of classified information to the delivery of inferior goods under a government contract.

The government is expected to investigate and prosecute more cases under the FCA involving ethical violations and organizational conflicts of interest as well. And since

government contractors must certify compliance with a host of regulations including environmental protection laws, employment and labor standards, small and disadvantaged business set-aside rules, and other federal regulations to obtain a government contract, any false certification may constitute a violation of the FCA.

The government is not required to show that a contractor actually intended to defraud the government of contract funds. The government or a whistleblower can establish a FCA violation by showing that a contractor knowingly, recklessly or with "deliberate ignorance" made a false statement, if the statement is connected in a reasonably direct way to contract requirements. The knowledge requirement to establish a FCA violation is lower than what is required to show common law fraud.

What can a contractor do to protect itself?

If a contractor is not equipped to successfully navigate the new procurement environment, it is simply asking for trouble. With huge potential damages and civil penalties in FCA cases, the additional risks of potential suspension and debarment, and possible criminal prosecution for FCA violations, it is crucial that contractors take preventive action.

The following are important steps a contractor can take to mitigate the risks inherent in government contracting and to avoid potential procurement fraud situations from occurring.

- Signing and submitting contract documents, progress reports, certifications, invoices, timesheets associated with a government contract without fully reading or independently verifying the accuracy of the information is a serious mistake. But contractors do it all the time. The failure to ascertain the truth of any statement made to the government can rise to the level of "deliberate ignorance" under the FCA.
- It is critically important that a contractor has internal corporate controls over all accounting and finance operations. Prices charged to the government for any good or service must be independently verifiable. All costs must be analyzed and adequately documented to ensure a contractor is not overcharging the government. A contractor's internal controls should also monitor subcontractor activities.
- Management must play an integral role in a contractor's procurement activities, providing oversight from bid preparation and submission to contract performance to contract closeout. A contractor should designate a corporate compliance officer whose primary function is to monitor the company's compliance with federal regulations associated with government contracting.
- A contractor should be diligent about understanding and following the many rules of procurement. In particular, the company should already have an effective internal compliance program devoted to ethics and standards of conduct in government contracting. If a contractor does not have an adequate compliance program, it should take immediate steps to implement one. It is equally important that all employees understand and obey federal contracting rules, which means a contractor should implement training programs and periodic refreshers for employees on compliance.
- If a contractor uncovers a potential procurement fraud it should immediately consult with counsel to determine whether corrective action and a voluntary disclosure to the government are in order.